SUMMARY

FOUR RECENT REPORTS WARN OF DANGER OF BUDGET DEFICITS

PREPARED BY: DEMOCRATIC STAFF, SENATE BUDGET COMMITTEE

February 12, 2004

Budget Experts Call For Bringing Deficits Under Control Before It Is Too Late And Cite Concern About Impact on U.S. and World Economies

Four recent independent reports raise serious concerns about the impact that large structural U.S. budget deficits projected under President Bush's policies will have on the U.S. and world economies. Budget deficits are expected to top $500 billion in 2004, according to Bush administration officials, and continued large budget deficits are projected for the balance of the decade assuming President Bush's policies are enacted. These new reports include: 1) a study by the Congressional Budget Office, 2) a critique by the International Monetary Fund, 3) a research paper presented by former Treasury Secretary Robert Rubin and economists Peter Orszag and Allen Sinai, and 4) a new book produced by the Brookings Institution and edited by former OMB Director Alice Rivlin and former OMB Associate Director Isabel Sawhill. All describe the bleak long-term budget outlook, warn that the U.S. cannot simply grow itself back to surplus, and urge the U.S. government to take decisive action to reduce long-term deficits.

CBO Study, "The Long-Term Budget Outlook"

In late December, CBO issued the latest version of its periodic study of the long-term budget outlook. In this latest report, the agency warned that *"[a]n ever-growing burden of federal debt held by the public would have a corrosive and potentially contractionary effect on the economy."*
The study went on to say that growing U.S. debt would most likely:

- crowd out private capital formation,
- slow the growth of the economy, and
- in the extreme, cause a sustained economic contraction.

CBO also cautioned that *"economic growth alone is unlikely to bring the nation's long-term fiscal position into balance."*

Notably, CBO's study confirmed that adopting President Bush's proposal to make all of his tax cuts permanent, while reforming the Alternative Minimum Tax and maintaining current spending policies, will lead to an explosion of deficits for years into the future.[1] Chart 1 shows the skyrocketing trajectory of deficits as a percent of GDP under this scenario as outlined by CBO in its report.

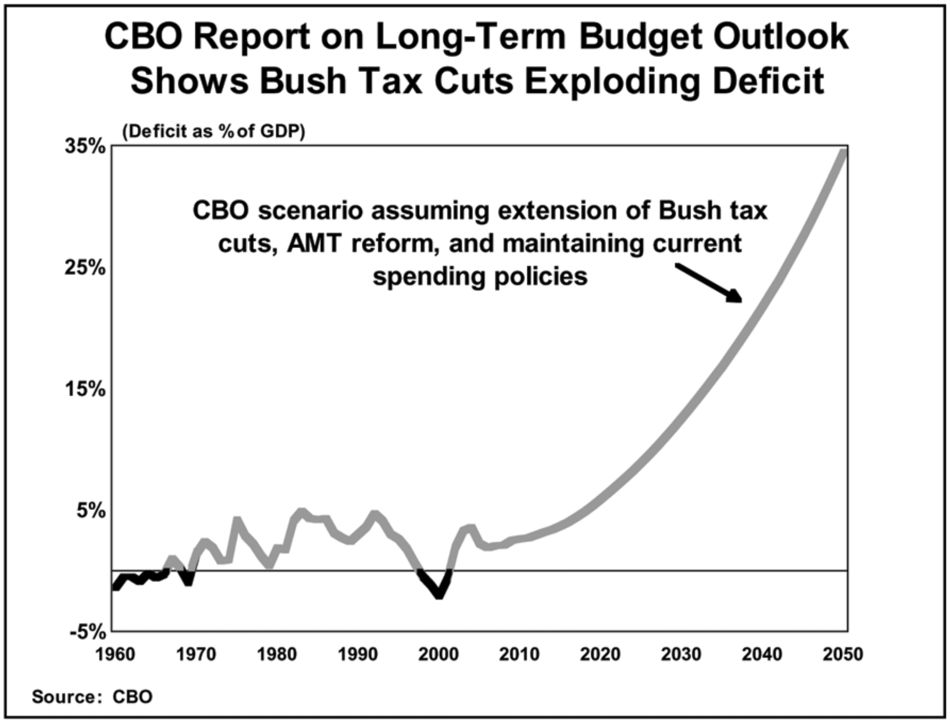

Chart 1

IMF Study, "U.S. Fiscal Policies and Priorities for Long-Run Sustainability"

On January 7, IMF issued a critique which similarly warned of the dangers that continuing budget deficits pose to the international, as well as the American, economy. The IMF study noted that the return to large deficits raises two interrelated concerns:

- *"First...the recent emphasis on cutting taxes, boosting defense and security outlays, and spurring an economic recovery may come at the eventual cost of upward pressure on interest rates, a crowding out of private investment, and an erosion of longer-term U.S. productivity growth.*
- *Second, the evaporation of fiscal surpluses has left the budget even less well prepared to cope with the retirement of the baby boom generation...and place massive pressure on the Social Security and Medicare systems. Without the cushion provided by earlier surpluses, there is less time to address these programs' underlying insolvency before government deficits and debt begin to increase unsustainably, making more urgent the need for meaningful reform."*

The IMF study also warned that U.S. budget deficits posed *"significant risks for the rest of the world."*

---

[1] CBO's scenario most closely matching current spending policies assumes mandatory program policies are unchanged, defense spending follows FYDP through 2022 and grows with inflation thereafter, and nondefense discretionary spending is maintained at the level projected for 2006 as a percent of GDP (3.6 percent, the average for the last 20 years).

Assuming the U.S. budget deficit grows as expected over the next decade, the IMF predicts world interest rates would rise by one-half to one percentage point. The IMF warns: *"Higher borrowing costs abroad would mean that the adverse effects of the U.S. fiscal deficits would spill over into global investment and output."*

And in yet another disturbing finding, the IMF concluded that the record budget deficit, when coupled with America's ballooning trade deficit, could even lead to a global currency crisis. The IMF noted that the U.S. *"is on course to increase its net external liabilities to around 40 percent of GDP within the next few years – an unprecedented level of external debt for a large industrial country. This trend is likely to continue to put pressure on the U.S. dollar...the possible global risks of a disorderly exchange rate adjustment, especially to financial markets, cannot be ignored."*

Chart 2 shows the dramatic drop in the value of the dollar compared to the Euro over the last two years. If foreign creditors were to become fearful of a further sharp drop of the dollar, the rush to withdraw from the U.S. market could be destabilizing to our economy.

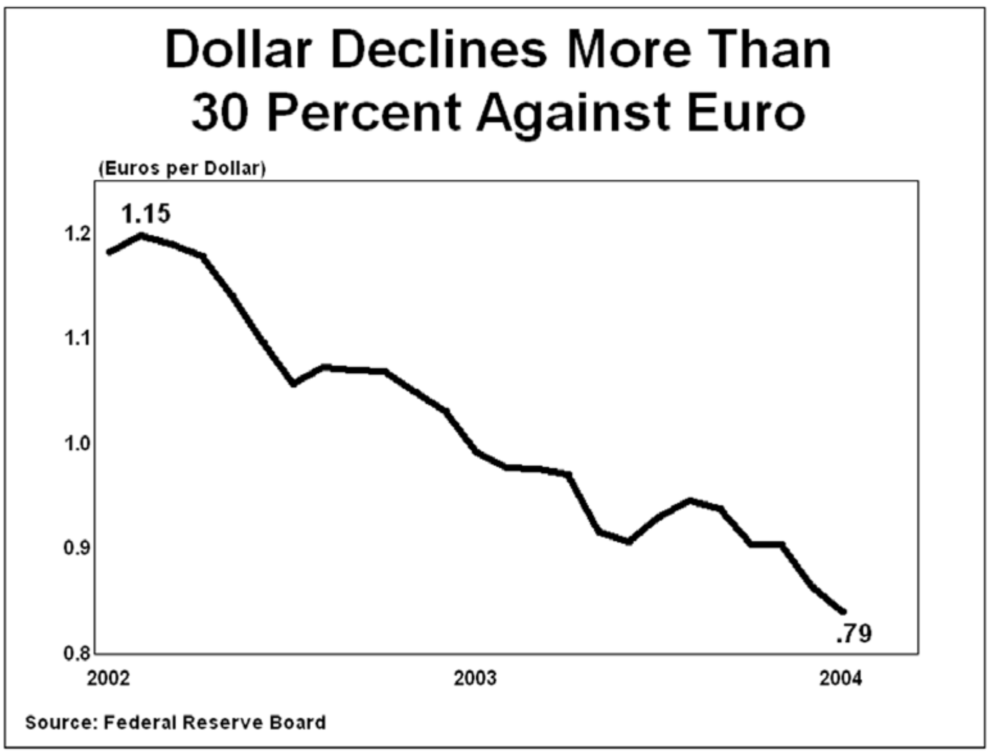

Chart 2

Finally, the IMF pointed out that any potential benefits from President Bush's recent tax cuts will ultimately be outweighed by the negative impact of the deficits they create. The IMF study stated: *"The modest efficiency gains that might arise from the recent tax cuts will also have to be weighed against the effects of a prolonged period of fiscal weakness...[T]he estimates ...suggest that the short-term stimulus stemming from the FY2004 budget proposals is likely to wane in several years, with higher deficits beginning to crowd out private investment and dampen output thereafter. In one simulation, for example, the tax cuts would eventually lower U.S. productivity – in terms of labor output per hour—by ½ percent in the long run."*

Rubin-Orszag-Sinai Paper, "Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray"
On January 4, former Treasury Secretary Robert Rubin and economists Peter Orszag and Allen Sinai issued an economic paper warning that *"the scale of the nation's projected budgetary imbalances is now so large that the risk of severe adverse consequences must be taken very seriously*." The Rubin-Orszag-Sinai paper noted that the budget is on an unsustainable path and that *"the adverse consequences...may well be far larger and occur more suddenly than traditional analysis suggests."* Like the IMF, the authors of this paper worry that the combination of large, chronic budget deficits and U.S. trade deficits could trigger a damaging currency crisis.

Rubin, Orszag, and Sinai also expressed their concern that further delay in acting to stem the flow of red ink will greatly exacerbate the problem in the years ahead. They stated: *"Failing to act sooner rather than later...only makes the problem more difficult to address without considerable instability, raises the probability of fiscal and financial disarray at some point in the future, and runs the risks of further constraining policy flexibility in the future."*

Further, the Rubin-Orszag-Sinai paper disputed the notion that spending restraint alone can solve the budget imbalance. The study concluded that *"balancing the budget for the longer term will require a combination of expenditure restraint and revenue increases."* Until broad political support develops for reducing budget deficits, the authors believe *"the single most important act Congress and the Administration could take at this point to rein in the budget over the next decade would be to re-establish the budget rules that existed in the 1990s. These put caps on discretionary spending and required that reductions in taxes or increases in mandatory spending be paid for with other tax increases or spending cuts."*

Brookings Institution Book, "Restoring Fiscal Sanity: How to Balance the Budget"
On January 12, the Brookings Institution released a book, edited by former OMB Director Alice Rivlin and former OMB Associate Director Isabel Sawhill, which, like the other studies and papers, argued that the *"nation's fiscal situation is out of control and could do serious damage to the economy in the coming decades."*

The Brookings book said deficits are harmful for five reasons:

- They slow economic growth.
- They increase household borrowing costs.
- They increase indebtedness to foreigners.
- They require that a growing proportion of revenues be devoted to paying interest on the national debt.
- They impose enormous burdens on future generations.

Like the IMF study, in addressing President Bush's tax cuts, the Brookings book stated: *"it's hard to escape the conclusion that recent tax cuts have done little if anything to improve the nation's long-term growth prospects and may have harmed them. What is needed to enhance long-term growth is higher national savings – not the lower savings generated by bigger deficits."*

* * *

Senate Budget Committee Democratic Staff, Dirksen 624
Contact: Stu Nagurka (202) 224-7436 or Steve Posner (202) 224-7925